NEW YORK COURT OF APPEALS ROUNDUP

POLICIES COVERING DIRECT PHYSICAL LOSS DO NOT APPLY TO COVID BUSINESS INTERRUPTION LOSSES

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In *Consolidated Restaurant Operations v. Westport Insurance*, the Court of Appeals recently clarified that insurance policies providing coverage for "direct physical loss or damage" to an insured's premises do not apply to business interruption losses sustained as a result of the COVID-19 pandemic absent some actual, material alteration to those premises or a complete and persistent dispossession from the premises.

In a decision written by Judge Caitlin J. Halligan and joined by Judges Jenny Rivera, Michael Garcia, Madeline Singas, Anthony Cannataro and Shirley Troutman and Justice Francesca E. Connolly of the Appellate Division, Second Department (Chief Judge Rowan D. Wilson took no part in the decision), the court affirmed a decision of the Appellate Division, First Department and dismissed a breach of contract and declaratory judgment action brought by a restaurant company against its insurance carrier.

Plaintiff Consolidated Restaurant Operations owns and operates dozens of restaurants and obtained an "all risk" commercial property insurance policy governed by New York law from defendant Westport Insurance Corporation for the period July 1, 2019, through July 1, 2020. The policy contained standard language providing coverage for "all risks of direct physical loss or damage to insured property" and business interruption or "time element" coverage for losses "directly resulting from direct physical loss or damage" to the insured property.

For those of you who recently emerged from a Rip Van Winkle–like five-year slumber, starting in late 2019 and early 2020, the COVID-19 pandemic created worldwide havoc with respect to human health and also to the global economy. Many businesses, including the plaintiff's, were forced to curtail operations or shut down entirely and suffered significant losses in revenue. The plaintiff submitted a claim to defendant for the revenue it lost as a result of the presence of the coronavirus in its restaurants and the government restrictions on nonessential businesses.

When defendant denied coverage, plaintiff commenced an action in Supreme Court, New York County for breach of contract and a declaratory judgment as to defendant's obligations under the policy. Defendant moved to dismiss for failure to state a cause of action on the grounds that, as a matter of law, plaintiff could not establish that the coronavirus caused direct physical loss or damage to the insured premises.

The Supreme Court granted the motion to dismiss and then denied as futile a motion to amend the complaint. The First Department affirmed the dismissal of the complaint and the part of the subsequent order that denied leave to amend. 205 A.D.3d 76, 87 (1st Dep't 2022). The Court of Appeals granted leave to appeal from the First Department order to the extent it affirmed dismissal of the complaint and granted judgment in favor of the defendant.

The court discussed the standards for granting a motion to dismiss and the contract interpretation principles governing insurance contracts, noting that unambiguous provisions of an insurance contract—like any contract—are to be given their plain and ordinary meaning and that any ambiguity should be construed in favor of the insured and against the insurer.

The plaintiff argued that the lower courts erred by not interpreting the phrase "direct physical loss or damage" broadly enough to encompass losses occasioned by any physical event on the insured premises that impairs its functionality or renders it unusable for its intended purpose. The plaintiff also argued that, to the extent that the policy does require some physical alteration of the insured property, its allegations concerning the presence of coronavirus droplets in the premises met this standard.

The Court of Appeals rejected each of these arguments in turn. It found that the phrase "physical damage" requires some form of material physical alteration to the property or a complete and persistent dispossession from the premises rather than just a partial or complete loss of use for a limited period of time.

It noted that its interpretation is supported by the fact that the policy provides coverage for "time element" (i.e., business interruption) loss that directly results from direct physical loss or damage. That would be superfluous if a limited period of lost use itself constituted "physical damage or loss" triggering coverage. While the plaintiff alleged that it had to suspend or severely curtain operations and limit on-premises dining, it did not allege a complete shutdown and, even as to the 30 restaurants that plaintiff alleged it was required to close, plaintiff did not allege that the premises themselves were contaminated to the point of uninhabitability.

The court also rejected the plaintiff's argument that it had sufficiently alleged a physical alteration of the insured property. The plaintiff's complaint contained allegations concerning the presence of coronavirus droplets on the premises and asserted that those droplets compromised the physical integrity of the building, but it failed to allege that there was any need to repair or replace any part of the property. Moreover, the plaintiff's own allegations confirm that the presence of the coronavirus in its restaurants was only temporary and not a permanent alteration of the premises.

While this was an issue of first impression under New York law for the Court of Appeals, the court noted that the plaintiff did not identify, and the court has not discovered, any other state or federal decision finding coverage for COVID-19–related business interruption losses under policy language similar to the standard policy language at issue here.

The clarity provided by this ruling is particularly significant given the large number of insurance contracts that are governed by New York law and given New York's importance as a leading business and financial center.

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